



# A New Entity

## Choosing the Right Structure for a Startup

One of the first decisions an entrepreneur must make is how to legally structure the new business, especially to get the best tax advantages. "As a general rule, it's hard to go wrong with an LLC for a small business," says Troy Blanchard, St. George corporate and tax attorney. LLCs taxed as partnerships, are flexible and can be used for virtually any type of business owner. If, for any reason, a corporate form becomes preferable, it is usually simple to convert an LLC to a corporation or to use "check the box" IRS procedures to have an LLC taxed as a corporation. However, some startup owners may still prefer S corporations to get maximum employment tax benefits.

### The Top Choices

"Business owners want to protect their personal assets from liability for business debts. Both LLCs and corporations provide that protection," explains Blanchard. A creditor that sues Newco, LLC or Newco, Inc. for failure to deliver a product on time cannot recover damages from Newco's owner, so long as Newco has been set up and maintained correctly. By contrast, sole proprietorships provide no protection from liability for business debts, and partnerships provide only limited protection.

Owners of startup companies usually want "pass-through taxation," which means that the company pays tax only at the owner level, rather than at both the company and owner levels. LLCs have pass-through taxation, with single-member LLCs being "disregarded entities" for IRS purposes and multiple-member LLCs being taxed as partnerships. The owners of a corporation can also obtain pass-through taxation by making an election with the IRS to become an "S corporation," or "S corp."

Because of those twin characteristics of limited liability and pass-through taxation, LLCs and S corps are favorites of lawyers and accountants when setting up new businesses.

### Advantages of LLCs

LLCs taxed as partnerships, are the clear choice of entity for real estate ownership. "You usually can't pull real estate out of an S corp without it being taxed," says Blanchard. For instance, if multiple family members own an apartment building, held in an S corp, and then want to remove it from the S corp, so as to give some members property interests and some members cash, they will be taxed. With an LLC, it is easier to pull real estate in and out, without triggering tax.

Corporations and multiple member LLCs can be owners of LLCs, whereas they cannot be owners of S corps. S corps can only have one class of stock, whereas there can be various types of ownership interests within an LLC. State statutes require that annual meetings of shareholders be held for S corps, whereas there is no such requirement for LLCs.

Under IRS "check the box" regulations, LLC owners can now specify to the IRS that, although they are structured under state law as an LLC, they want to be taxed as a corporation. They can thus obtain the flexible structure of an LLC, while keeping the tax benefits of an S corp.

### Advantages of S Corps

"The number one reason for using an S corp is minimizing employment taxes," says Blanchard. An S corp owner is clearly treated as an employee for tax purposes. S corp owners can pay themselves reasonable salaries, and the amount of profit above the salary escapes deductions for social security and Medicare. By contrast, there is, at best, ambiguity as to whether LLC owners may be treated as employees for purposes of deductions for social security and Medicare. For a small business owner, there can be a substantial tax hit if he/she cannot be treated as an employee.

The statutes and case law of corporations have been around for centuries, whereas the first LLC laws were enacted in the United States in

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St. George attorney

1987. There is thus much more guidance for attorneys on the way a court will treat a corporation in various circumstances, as compared to how it will treat an LLC. For business owners who prize greater certainty in how the courts will act, as well as business owners who have used corporations in the past and are simply more comfortable with them, an S corporation may make sense.

Venture capitalists and private equity investors often require that a corporation be used to hold their investment. For the minority of startup businesses using that type of financing, neither an LLC nor an S corp may work.

### Get the Documents Right

"So many LLC operating agreements are written as if the LLC will be taxed as a partnership, even though the owners have 'checked the box' to be taxed as a corporation," Blanchard comments. Whatever ownership structure is used, a company's formation documents should be carefully drafted. Business owners doing their own online filings may create Articles of Incorporation or Organization, but have no bylaws, shareholders agreement or operating agreement. They may have no documentation showing how ownership is divided, what rights minority or majority owners hold, what each owner is contributing or how various tax issues will be handled. Equally as important as choosing the correct entity is properly documenting that choice. **UB**